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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JAMES M. IRVIN
COMMISSIONER
WILLIAM A. MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	**DOCKET NO. T-01051B-99-0105** **STAFF'S NOTICE OF FILING REBUTTAL TESTIMONY RE SETTLEMENT AGREEMENT**

The Arizona Corporation Commission Staff ("Staff") hereby files the Rebuttal Testimony - RE Settlement Agreement of Michael L. Brosch, William Dunkel, and Harry M. Shooshan III in Support of its October 20, 2000 Settlement Agreement with Qwest Corporation ("Qwest") formerly U S WEST Communications, Inc. in the above-captioned case.

RESPECTFULLY SUBMITTED this 20th day of November, 2000.

By: _____

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BEFORE THE

ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATIONS, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	)	DOCKET NO. T-01051B-99-0105

REBUTTAL TESTIMONY

OF

WILLIAM DUNKEL

REGARDING SETTLEMENT AGREEMENT

ON BEHALF OF

THE STAFF OF THE ARIZONA CORPORATION COMMISSION

NOVEMBER 20, 2000

I. INTRODUCTION

Q. ARE YOU THE SAME WILLIAM DUNKEL WHO PREVIOUSLY SUBMITTED TESTIMONIES IN THIS PROCEEDING?

A. Yes.[1] My qualifications and experience were included in my Depreciation Direct testimony in this proceeding.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY REGARDING THE SETTLEMENT AGREEMENT?

A. The primary purpose of this Rebuttal testimony regarding the Settlement Agreement is to respond to the testimonies of other parties pertaining to certain rate design issues in the Settlement Agreement between Staff and Qwest.

Q. ON PAGE 2 OF MR. JOHNSON'S SUPPLEMENTAL TESTIMONY, MR. JOHNSON EXPRESSES THE CONCERN THAT:

> For instance, targeted price cuts may be used to discipline or punish certain of its competitors. Moreover, rate reductions may be used in a preemptive manner, to make competitive entry more difficult or impossible. Similarly, prices may be reduced to the point where competing carriers cannot cover their costs, including the cost of winning customers and gaining market share."

DOES THE STIPULATION ATTEMPT TO LIMIT THESE ANTI-COMPETITIVE USES OF PRICING FLEXIBILITY?

A. For Basket 1 services, the Agreement requires:

[1] Throughout this testimony, my "Direct testimony on Modernization, Depreciation, and RCNLD Issues" will be referred to as my Direct Depreciation testimony. My "Direct Testimony on Rate Design Issues" will be referred to as my Direct Rate Design testimony.

> All services in this Basket shall be continued statewide at the tariffed rate, unless or until the Commission orders retail geographic rate deaveraging, or unless Qwest demonstrates a cost difference for the new service on which to base the price difference.[2]

This provision effectively prevents Qwest from cutting the price for a Basket 1 service in one area in order to disadvantage competitors or potential competitors in that area without reducing the prices statewide. Therefore, this provision does limit Qwest's ability to use its price flexibility in an anti-competitive manner for Basket 1 services.

Under Basket 3, the Company is generally allowed to offer different services to different customer groups or in different geographic locations:

> New services and packages in Basket 3 may be offered to selected customer groups based on their purchasing patterns or geographic location, for example. This provision shall not be construed to permit red-lining based on criteria such as wealth or race, or to permit Qwest to discriminate against any class of customers in violation of A.R.S. Section 40-334.[3]

Section 40-334 prohibits "undue" discrimination.

Q. IN HIS SUPPLEMENTAL TESTIMONY, DR. JOHNSON DISCUSSES THE IMPUTATION REQUIREMENT. DOES THE AGREEMENT CHANGE THE IMPUTATION REQUIREMENT?

A. No, it does not.

> Nothing in this Price Cap Plan is intended to change or modify in any way the imputation requirements contained in A.A.C. R14-1-1310.[4]

If in the future, Dr. Johnson or other parties believe that the imputation requirements are not being met, they could bring that to the Commission's attention. The Agreement clearly requires

[2] Attachment A, Part 2(c) (v), Price Cap Plan.
[3] Part 4(g), Attachment A, Price Cap Agreement.

that those imputation requirements must be met, and nothing in the Agreement changes the imputation requirements.

Q. IN MS. STARR'S TESTIMONY, SHE PROPOSES THE COMMISSION

> Eliminate the carrier common line charge and interconnection charge, which have no cost basis and are merely subsidies being provided to Qwest by IXCs at the ultimate expense of end users.[5]

IS IT TRUE THE CARRIER COMMON LINE CHARGE (CCLC) HAS NO "COST BASIS" AND IS A SUBSIDY?

A. No. There are very significant costs involved. The Carrier Common Line Access service utilizes the loop facilities of Qwest. The carriers, including AT&T, use the loop facilities to terminate calls to premises, and also to originate calls from premises. There is a significant cost to Qwest to provide and maintain those loop facilities. The CCLC is simply the charge whereby the IXCs support a portion of the cost of those loop facilities which they are sharing and utilizing. If the CCLC were eliminated, but the IXCs were still allowed to utilize the loop facilities, that would mean the IXCs would be getting a free ride on those loop facilities. The CCLC is not excessive. For most locations, paying the CCLC, and therefore using the shared loop facility, is the lowest cost way for AT&T and other IXCs to connect traffic to and from the premises.

The claim that the CCLC has no cost basis is false. There are two standard costs that must be calculated in order to properly evaluate a price. These are the TSLRIC "floor" and the "stand alone" cost (SAC) "ceiling." The loop cost is part of the SAC of Carrier Common Line Access

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[4] Part 3(g), Attachment A, Price Cap Agreement.
[5] Page 12, Starr Testimony.

Service. This is true because the loop facility would have to exist to provide Carrier Common Line Access service even if no other services were being provided (stand alone). At the other extreme, the TSLRIC floor excludes all joint and common costs, and therefore the cost of the loop facility would be excluded from the properly calculated TSLRIC of any service that shares that facility. The reasonable, proper, and subsidy-free price for a service is a price that is between the TSLRIC floor and the SAC ceiling.[6] Since the cost of the loop facility is part of the SAC of switched access and Carrier Common Line Access Service, the loop facility cost is properly included in establishing the upper limit of the range in which the subsidy free, reasonable carrier switched access rates fall. This is discussed in more detail on pages 97 through 100 of my Rate Design Direct Testimony. These widely accepted principles are discussed in the following quotation from an FCC Order:

> Economists would say that in order to give incumbent local exchange carriers the proper incentives to build multi-service facilities, where such facilities are economically rational, cost allocated to each individual service or subset of services should be less than the stand-alone cost but greater than the incremental cost. ... These are the upper and lower bounds within which costs allocated to regulated and nonregulated services should fall.[7]

No one requires AT&T to use Qwest loops, and therefore pay the CCLC. That is entirely AT&T's choice. The fact that AT&T chooses to use the Qwest loop and pay the Qwest CCLC clearly demonstrates that carrier access service is not a "cost free" service. If there was "no cost" to provide Carrier Access Service, then AT&T would provide that service itself at "no cost", and stop paying Qwest the CCLC. Of course, carrier access service is not a "no cost" service. Loop facilities must be installed and maintained in order for Carrier Access Service (along with other services) to be provided.

[6] Technically, it would also be subsidy free if it is equal to the SAC ceiling, or equal to the TSLRIC floor.

Q. WHAT WOULD BE THE RESULT OF THE ELIMINATION OF THE CCLC?

A. The result would be that AT&T would be allowed to take a "free ride" on the loop facility of Qwest. AT&T would be allowed to use the loop facility to originate and terminate toll calls, but contribute nothing towards the cost of those facilities.

Q. HAS AN AT&T WITNESS IN ANOTHER STATE STATED THE PROVIDING A FREE RIDE ON THE LOOP FACILITY WOULD BE IMPROPER?

A. Yes. Mr. Turner, testifying on behalf of AT&T Communications in Texas, in a very recent testimony stated that allowing the DSL providers to utilize the loop facilities at no charge would

> discriminate against facilities-based CLECs by giving other competitors a 'free ride' on the loop.[8]

Mr. Turner also stated,

> A zero price for HFPL [high-frequency portion of the loop] is both anti-competitive and unjustified when viewed in the light of the entire telecommunications marketplace.[9]

This AT&T witness further stated,

> A zero price for the HFPL permits the CLECs to bear no cost for one of the most important assets they utilize in providing their service.[10]

AT&T's testimony in the Texas proceeding is clearly inconsistent with the position AT&T is presenting in this Arizona case. Even AT&T recognizes that giving companies a "free ride" on the loop facilities is improper, as is demonstrated by AT&T's testimony in Texas quoted above.

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[7] Paragraph 20, FCC Notice of Proposed Rulemaking, CC Docket No. 96-112, adopted and released May 10, 1996.
[8] Prefiled Testimony of Steven Turner, filed on behalf of AT&T Communications of Texas L.P. before the Public Utilities Commission of Texas, Docket Nos. 22168 and 22469, September 5, 2000, pages 17-18.
[9] Turner, page 16.
[10] Turner, page 16.

However, in this proceeding, AT&T violates that concept by effectively proposing that AT&T and other IXCs receive a "free ride" on the loop facilities.

Q. ON PAGE 28 OF DR. SELWYN'S SUPPLEMENTAL REBUTTAL, HE ARGUES THAT THE SWITCHED ACCESS RATES ARE HIGHER THAN ITS INCREMENTAL "COST." IS IT PROPER TO SET PRICES ABOVE INCREMENTAL COST?

A. Yes, as was discussed in Mr. Regan's testimony:

> The proper range for a price is between the TSLRIC price floor and the Stand-Alone price ceiling. This is the range of subsidy-free rates where prices should generally fall. If a service is priced above its TSLRIC floor, this is not indicative of a problem, since prices are generally set above the floor to provide contribution toward the shared, joint and common costs of providing services. If a service is priced below its Stand-Alone ceiling, this is not indicative of any pricing problem either, since prices are normally set below their ceiling.[11]

Pricing above the direct cost or TSLRIC of a service is how the common/joint/shared costs of a company are recovered. For example, pricing above the direct cost of products is how stores and restaurants pay their rent and other joint and common costs. In the telephone industry, the cost of the loop facility is the largest shared facility cost. For Qwest in Arizona, their investment in the loop represents 56% of their investment in all facilities.[12] Since the switched access services share the loop facilities, it is appropriate that they be priced to provide a contribution to the costs of those shared loop facilities costs upon which switched access (along with many other services) depends.

[11] Page 7, Regan Direct.

[12] Qwest 1999 ARMIS Report 43-04, $685,528 (line 1275-COE Cat 4.13 Excl. Circuit Equipment-Jointly Used) + $2,024,056 (Line 1455-C&WF Cat 1 Excluding Line Joint Used Inv) divided by $4,799,921 (line 2194) = 56.45%.

The properly calculated TSLRIC "floor" of a service does not include any portion of the shared, joint and common costs. If a service was priced at TSLRIC, it would be making no contribution to many of the shared, joint, and common costs (shared costs). Even if a service uses, depends upon, and shares facilities, no part of certain shared costs are included in the properly calculated TSLRIC. This is reasonable because TSLRIC is only meant to be the "floor." Zero recovery of those shared costs is the minimum possible recovery, and therefore this establishes a "floor." However, this does not establish the reasonable or fair price. At the other extreme, the SAC includes 100% of the cost of all facilities needed to provide a service, even if those facilities are shared with other services. One hundred percent is the maximum possible inclusion. Therefore, this is a ceiling. The reasonable price is between these two extremes, which effectively means the reasonable price for a service is set to cover all of the costs that are directly caused by only that service, plus provide a contribution which supports a portion of the cost of the shared facilities.[13]

The switched access rates that will result from the Stipulation are well below the stand alone "ceiling". Therefore, these rates are not producing a subsidy. They are also well above their TSLRIC floor. This means they are not receiving a subsidy.[14] Therefore, these rates will be in the subsidy-free range, which is where prices are normally expected to fall. The switched access rates will be covering their direct cost (TSLRIC), plus making a contribution to cover a portion of the costs of the shared facilities which they share.

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[13] Technically, the price is subsidy free if it is between these two ranges, or if it is equal to either the SAC or TSLRIC. The SAC actually includes all of the cost of the facilities that would be needed to provide that service. In the case of the loop, there is no reason to believe that the cost of the loop needed to provide switched access service, for example, would be significantly different than the cost of the loop needed to provide several services.

[14] A service is receiving a subsidy only if it is priced below its TSLRIC floor. A service is producing a subsidy only if it is priced above its stand alone ceiling. A service that is priced between these two extremes (or equal to one of them) is neither receiving nor producing a subsidy. See pages 3 and 6 of Mr. Regan's Testimony.

Q. DR. COLLINS' TESTIMONY RECOMMENDS THAT INSTEAD OF USING THE TSLRIC AS THE "FLOOR", THE COMMISSION SHOULD USE THE SUM OF ALL OF THE UNES (PLUS OTHER COSTS) AS THE "FLOOR." DR. COLLINS STATES:

> ...the price floor of a service should be the full cost incurred in providing the service. Here, that price is the sum of the imputed TELRIC costs for the UNEs which technologically allow the service; any appropriately assigned balance of joint/shared cost; an appropriate amount of assignable common cost; and any specific cost to market the service.[15]

IS THE COST THAT INCLUDES THE FULL COST OF ALL THE UNES OF FACILITIES NEEDED TO PROVIDE THE SERVICE PROPERLY INCLUDED IN THE "PRICE FLOOR"?

A. No. There is no "one-to-one" mapping between UNEs and "service" prices. The UNE prices are for facilities, but many of those facilities are shared by many different services. To take a simple example, assume a street vendor's cart is used to sell both ice cream cones and ice cream bars.[16] When establishing a "floor" price that could reasonably be charged for cones, it would be inappropriate to include the full cost of the vendor's cart in the cost that had to be recovered from the price of the cones, because the cart is used for more than one product. The full cost of the cart would be included in the SAC of the cones, but that is the ceiling. The reasonable price would be below that ceiling. Including the full cost of shared facilities in the cost of one service that shares it is a SAC analysis which determines the "ceiling", but the shared facilities cost should not be included in determining the "floor" for a service that shares facilities.

[15] Page 13, line 25, Collins' November 13, 2000 Testimony.

[16] This assumes the cost of the cart is a fixed cost that would not change if either ice cream cones or ice cream bars, or both were sold from the same cart.

For example, the loop facility is required to provide toll service. Therefore, the "stand alone" cost of toll includes the loop cost. However, that "stand alone" cost is the ceiling for the reasonable rate, not the "floor." When facilities are shared, the recovery of the cost of those facilities also has to be shared among the services that share that facility. Putting 100% of the cost of a facility that is shared by several services in the cost of just one of those services does not establish the appropriate "floor" price for that service. Instead, 100% is the maximum possible allocation of the shared costs, and therefore is included in establishing the "ceiling."

The full cost of all facilities needed to provide a service is the "stand alone" cost, which is appropriately the price ceiling. Calculating the costs including the full cost of all elements (even the full cost of the shared facility) needed to provide the service is a valid calculation, but that is the calculation for the "ceiling" not the floor. The TSLRIC is the price floor. All of this is discussed in more detail in Mr. Regan's testimony filed in this proceeding.

Q. THROUGHOUT HER TESTIMONY, MS. STARR OBJECTS TO THE $15 MILLION SWITCHED ACCESS REDUCTION AS BEING INSUFFICIENT, AND PROPOSES THAT THE SWITCHED ACCESS REDUCTION SHOULD BE EVEN LARGER.[17] WHAT ELSE DOES MS. STARR COMPLAIN ABOUT?

A. The Agreement allows Qwest to increase the rate cap in Basket 3 by $10 million in order to offset the $10 million of Basket 2 switched access reductions that will occur in the last two years of the Agreement. However, on page 11, Ms. Starr objects to increasing the revenue cap in Basket 3 by $10 million. She points out this would increase some of the charges that AT&T pays in Basket 3.

Ms. Starr does not appear to recognize that the revenue requirement of Qwest must be recovered somewhere. Ms. Starr wants to see the rates reduced in Basket 2 more than they have been reduced in the Agreement, but she objects to the revenue loss being made up in the other baskets (or at least any other basket that would effect any AT&T rates). If you reduce revenues in one basket, you have to increase revenues in another basket, in order to recover the overall revenue requirement of the Company.

Q. DO YOU HAVE ANY FURTHER COMMENTS ON THE SWITCHED ACCESS RATE REDUCTIONS THAT ARE INCLUDED IN THE STIPULATION?

A. Yes. The $15 million annual reduction that is included in the Stipulation is significantly higher than the reduction that Qwest proposed. In its original testimony, Qwest proposed a $5 million annual reduction in switched access revenues. (See Dr. Wilcox's Direct Testimony) The settlement includes a reduction that is three times the reduction in the switched access rates that Qwest had proposed in this proceeding. It must be remembered this is a negotiated settlement.

In addition, even at present rates, switched access services were not producing an unreasonable level of contribution to the joint and common costs, including the loop costs, as discussed on page 100 of my Rate Design Direct Testimony. There is no evidence that the contribution to joint and common costs being received from switched access is excessive. The switched access rates are well below the switched access stand alone cost.

[17]On page 8, Mr. Starr proposes that rates should be reduced down to the interstate rate level.

Q. SOME OF THE IXCS PROPOSE THAT THE INTRASTATE SWITCHED ACCESS CHARGES BE SET EQUAL TO THE INTERSTATE SWITCHED ACCESS CHARGES WHICH RESULTED FROM THE FCC'S CALLS ORDER.[18] SHOULD THE STIPULATION BE MODIFIED TO ADOPT THAT CONCEPT?

A. No. Following the FCC CALLS Order would result in a large increase in fixed monthly charges to Qwest customers in Arizona. The low interstate "per minute" rates charged to carriers are achieved by charging end user customers a large End User Common Line (EUCL) charge, which is currently $4.35 per month[19], and scheduled to increase further in the future. This EUCL charge to end users has the effect of "buying down" the per minute access charges that the IXCs otherwise would have to pay. It is not in the public interest to impose a similar intrastate EUCL charge on customers.

Q. ON PAGE 31, DR. SELWYN DESCRIBES THE WHOLESALE SERVICE WHICH IS PRICED AT A 12% DISCOUNT FROM THE RETAIL RATE.[20] DR. SELWYN ALLEGES THAT THE PRICE OF THE "AVOIDED COST" DISCOUNTED WHOLESALE SERVICE WOULD NOT CHANGE WHEN THE RETAIL SERVICE PRICE CHANGED. IS THAT A VALID CONCERN?

A. I do not believe so. Part 3(c) of Attachment A of the Terms and Conditions states,

> UNE and discounted wholesale offerings are priced based on the provisions of the Telecom Act of 1996.

Section 252(d)(3) of the Telecom Act require that the wholesale rates be priced at an "avoided cost" discount from the retail rates. For example, for residential basic exchange service, this

[18] Dr. Selwyn, page 40, Supplemental Direct.
[19] This is the rate for the primary residential line and single line business customers. The EUCL charge is different for other categories of customers.

Commission requires that the Qwest "avoided cost" wholesale rate be 12% less than the Qwest retail rate. Therefore, if the retail rate is reduced, these requirements would result in that wholesale rate also being reduced, so as to maintain the 12% "avoided cost" discount from the retail rate.[21]

If it were true that the agreement would result in the avoided cost wholesale prices no longer being set at the "avoided cost" discount from the retail prices, I would also be concerned, but there is no basis for Dr. Selwyn's claim that this would be the effect of the Agreement. If Dr. Selwyn has any evidence on which to base his interpretation of this Agreement, he has not identified that basis in his testimony.

Likewise, on page 34, Dr. Selwyn alleges that:

> A Basket 2 wholesale price could actually exceed the Basket 3 retail price, and otherwise fail to reflect retailing costs that will be avoided when a service is furnished for resale, which would, in my view, violates the requirements of Section 252(d)(3).[22]

In addition, on page 35, Dr. Selwyn also alleges that the retail prices of "new" basket offerings may fall below the wholesale prices for those services. Dr. Selwyn provides no basis for these claims. There is no reason to believe that the stipulation allows these discrepancies. As previously discussed, the "avoided cost" discount requirement does apply under the Agreement. Therefore, these problems Dr. Selwyn alleges do not exist.

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[20] The "avoided cost" discount is 12% for residential basic and 18% for all other services.
[21] In the Telecom Act, the avoided cost wholesale rate is different from the UNE rate. The avoided cost wholesale rate is specifically a rate for a service, not a price for facilities, which is unlike the UNE rate which is a price for facilities.
[22] The section of the Telecom Act Dr. Selwyn refers to is the section that requires the "avoided" cost discount.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY REGARDING THE SETTLEMENT AGREEMENT?

A. Yes.

STRATEGIC POLICY RESEARCH

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-1051B-99-105

REBUTTAL TESTIMONY REGARDING SETTLEMENT AGREEMENT

HARRY M. SHOOSHAN III

STRATEGIC POLICY RESEARCH, INC.

November 20, 2000

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SUPPLEMENTAL REBUTTAL TESTIMONY OF HARRY M. SHOOSHAN III IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

Q. WHAT IS YOUR NAME AND OCCUPATION?

A. My name is Harry M. Shooshan III. I am a principal in, and co-founder of, Strategic Policy Research, Inc. ("SPR"), an economics and public policy consulting firm located at 7979 Old Georgetown Road, Suite 700, Bethesda, Maryland.

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN THIS PROCEEDING?

A. Yes. I filed Direct Testimony on August 9, 2000 and Surrebuttal Testimony on September 8, 2000 on behalf of Staff in which I proposed a price cap regulation plan for Qwest Corporation (formerly US WEST Communications, Inc.) in Arizona. Further, on October 27, 2000 I filed Direct Testimony in support of the Proposed Agreement ("Agreement") on behalf of Staff.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

A. This testimony responds to criticisms of, and disagreements with, the proposed price cap plan raised by Intervenors' experts Dr. Lee Selwyn on behalf of AT&T, Dr. Ben Johnson on behalf of RUCO, and Dr. Francis Collins on behalf of Cox Arizona Telecom. In preparing this testimony, I have reviewed the comments filed by the Intervenors regarding the proposed Settlement Agreement. These comments encompass many dozens of pages. Out of these, I have attempted to distill the major substantive concerns and criticisms expressed by the Intervenors regarding

the price cap plan portion of the Agreement. I respond to those concerns and criticisms in this Rebuttal Testimony.

Q. WOULD YOU PLEASE SUMMARIZE THOSE CONCERNS AND YOUR RESPONSES TO THE CONCERNS?

A. The issues that I address are those raised by these witnesses regarding the flexibility permitted for Basket 2 and Basket 3 services, as well as the potential for anti-competitive pricing by Qwest, under the terms of the proposed plan [Collins; Selwyn; Johnson Further Supplemental; Johnson Supplemental at 26-30]. I also respond to parties' criticisms of the agreed upon "X" factor [Selwyn at 13-24; Johnson Supplemental at 13-19]. I further respond to parties' testimony regarding the basket structure of the proposed price cap plan [Johnson Supplemental at 19-26]. Finally, I respond to Ms. Starr's and Dr. Selwyn's testimony regarding the adequacy of the $15 million per year reduction in access services for the three-year term of the plan [Starr at 7; Selwyn at 26-29].

As I describe in detail below, the concerns that Qwest could price anti-competitively under the terms of the plan are unfounded. The Agreement calls for services to be priced above TSLRIC. Further, imputation rules in Arizona will continue to be applied as they have been to ensure that no price squeeze occurs. The "X" factor in the plan, while developed and sponsored in my direct testimony, also reflects a compromise between the Company and the Staff, and is consistent with that adopted in other states, as I discussed in previous testimony [Shooshan Direct at 14]. The basket structure proposed in the plan separates basic/noncompetitive services from wholesale and competitive/flexibly-priced services, thereby preventing cross-subsidies as well as providing three degrees of pricing flexibility among retail services. While the agreed-upon reduction in intrastate access rates is less than my original recommendation, it is nonetheless a substantial movement in the right direction and represents one component of an Agreement that has sought to balance the interests of Qwest, its retail and wholesale customers, and competitors, and should be viewed in that light.

Q. HAVE ANY PARTIES FOUND THE TERMS OF THE PROPOSED AGREEMENT TO BE IN THE PUBLIC INTEREST?

A. Yes. On behalf of the U.S. Department of Defense and other Federal Executive Agencies ("DOD"/"FEA"), Richard Lee has testified that the Agreement does "strike an appropriate balance between the interests of Qwest and its ratepayers" [Lee at 3-4]. Mr. Lee astutely points out that the plan "appropriately places the burden on Qwest to realize the net revenue increase [from competitive services only] authorized under the Settlement Agreement" [Lee at 4]. It is important to keep these points in mind when reviewing the individual components of the Agreement.

1. RETAIL SERVICES BASKETS

Q. DR. JOHNSON AND DR. COLLINS CRITICIZE THE NUMBER OF RETAIL BASKETS IN THE PRICE CAP PLAN IN THE PROPOSED SETTLEMENT AGREEMENT AND RECOMMEND USE OF ADDITIONAL BASKETS [JOHNSON SUPPLEMENTAL TESTIMONY AT 19-23; COLLINS TESTIMONY AT 9-10]. DR. JOHNSON'S RECOMMENDATION ON BEHALF OF RUCO GOES THE FARTHEST. INSTEAD OF THE TWO RETAIL PRICE CAP BASKETS IN THE PRICE CAP PLAN IN THE PROPOSED SETTLEMENT AGREEMENT (BASKETS 1 AND 3), HE RECOMMENDS THAT FIVE BE USED: BASIC RESIDENCE, BASIC BUSINESS, DISCRETIONARY, EMERGING COMPETITIVE, FULLY COMPETITIVE. DR. COLLINS, TESTIFYING ON BEHALF OF COX ARIZONA TELECOM, RECOMMENDS REPLACING THE TWO BASKETS 1 AND 3 WITH THREE BASKETS: BASIC/ESSENTIAL NON-COMPETITIVE SERVICES, EMERGING COMPETITIVE SERVICES, AND FLEXIBLY-PRICED COMPETITIVE SERVICES. HOW WOULD YOU RESPOND?

A. Let me first address the question of the number of baskets for retail services. The Commission's rules provide for two classifications of retail services: non-competitive and competitive. The price cap plan in the proposed Settlement Agreement takes advantage of that existing framework. At the inception of the plan, Basket 3 includes only those services that have been afforded pricing flexibility or have been determined by the Commission to be competitive under the criteria set forth in A.A.C. R14-2-1108. A Basket 1 service may move to Basket 3 upon Qwest meeting those same criteria. By urging the use of additional retail baskets, Intervenors are, in effect, asking the Commission to change its policies regarding service classifications in the course of a rate case. In my opinion, such a change is both inappropriate and unnecessary. If Intervenors want the Commission to change its rules, they should enter through the front door with a petition for rulemaking and not through the back door of amending the Agreement. Moreover, it is unclear to me how placing additional pricing constraints on Qwest beyond those that exist today will advance competition. There is no evidence that I have seen to suggest the Commission's current rules have failed to advance competition or to protect consumers.

Dr. Johnson's proposal to have separate baskets for residential and business services would also add unnecessary complexity to the price cap plan. Dr. Johnson seems motivated, as the Staff has been, to provide additional protection for residence customers. To this end, Dr. Johnson's recommends three degrees of pricing flexibility, which the proposed plan in fact contains, but not in the specific form recommended by Dr. Johnson, which does not comport with Arizona classification of services. The proposed price cap plan provides protection by providing the least flexibility for a number of "basic" services that are subject to a "hard cap." These services include: flat rate residential, flat rate business, 2 & 4 party service, exchange zone increment charges, low use option service, service stations service, telephone assistance programs, and individual PBX trunks including features. The Agreement caps prices for these services at their levels going into the plan without an adjustment for inflation during the three-year term of the plan. Consequently, there

is no opportunity under the terms of the proposed settlement for Qwest to increase residential flat rate service while lowering a business service rate. With this vital protection in place, I believe it is important to give Qwest at least some limited ability to adjust prices between residence and business services in Basket 1, which is the next degree of pricing flexibility in the proposed plan. Qwest has the greatest pricing flexibility for services in Basket 3 which are, initially, those services for which Qwest has **already been granted** pricing flexibility. Maintaining this flexibility for services in Basket 3 is important if we are to reach a point where, over time, prices are realigned to reflect more closely the results that would be obtained in a competitive marketplace. That is, after all, the primary goal of regulation.

Finally, Dr. Johnson seems to be missing a key point. The Agreement seeks to move Arizona in line with the vast majority of states that are regulating by direct controls on prices rather than by indirect controls on earnings. By focusing regulation instead on what we really care about—the prices charged to basic telephone customers who today may only be beginning to have alternatives—and doing this by capping directly the prices of basic services, the Commission will be providing consumers and competitors with very real and effective protection against making basic telephone customers bear the risk for Qwest's attempts to compete elsewhere.

2. WHOLESALE SERVICES BASKET

Q. WHILE APPARENTLY SUPPORTING THE CONCEPT OF PLACING WHOLESALE SERVICES IN A SEPARATE BASKET, RUCO AND AT&T HAVE BOTH EXPRESSED CONCERN ABOUT HOW THE WHOLESALE SERVICES BASKET WOULD WORK [JOHNSON SUPPLEMENTAL TESTIMONY AT 19, 23; SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 22, 30-34]. HOW WOULD YOU RESPOND TO THEIR CONCERNS?

A. While I am pleased that they support the concept of a wholesale basket as I recommended in my initial testimony, I believe Intervenors misunderstand how the pricing of services is Basket 2 would be handled. Wholesale prices are set today according to specific pricing rules (both federal and state) and prior decisions by the Commission. The price cap plan explicitly states that these services will continue to be governed by such rules and decisions. In effect, each wholesale service is within its own "sub-basket" and changes to the price of any wholesale service would come only after a determination by the Commission. The exception to this rule is that intrastate switched access rates are to be reduced by $5 million a year for each of the three years. However, the "headroom" created by these reductions is provided in Basket 3, rather than Basket 2. This prevents an outcome where Qwest would reduce access charges but increase rates for UNEs, for example. It is for this reason that there is no price index for Basket 2. Qwest is given no automatic discretion to change the price for any component of this basket. The price cap plan includes no mechanism that would permit an increase in any Basket 2 service to offset a price decrease in either a Basket 1 or a Basket 3 service. The price cap plan further provides no mechanism for offsetting price changes among the services **within** Basket 2.

The Agreement leaves existing pricing rules and prices in place for all wholesale services. If competitors seek changes in such rules or prices, they can still proceed under the mechanisms available to them today.

3. BASKET 3 PRICING FLEXIBILITY

Q. RUCO'S WITNESS DR. JOHNSON EXPRESSED CONCERN ABOUT THE POTENTIAL INCREASE IN BASKET 3 RATES [JOHNSON SUPPLEMENTAL TESTIMONY AT 12-13]. HOW WOULD YOU RESPOND TO THIS CONCERN?

A. It is important to keep in mind that the only services initially in Basket 3 are those services that have been afforded pricing flexibility or have been determined by the Commission to be competitive. Because of the competitive nature of these services, it is highly unlikely that the scenario that Dr. Johnson suggests would take place, namely, dramatic increases in individual service prices, perhaps by as much as ten-fold, or more. Simply put, Qwest will find it very difficult—at least in the long run—to sustain price increases on Basket 3 services that are out of line with marketplace conditions, unless it wants to lose customers. In its classification decisions, the Commission has, in effect, determined that competitive marketplace forces are sufficiently strong for these services to provide a reasonable check on Qwest's pricing. The Commission will continue to use the same criteria in any reclassification decision that involves moving a Basket 1 service to Basket 3.

Q. RUCO'S WITNESS DR. JOHNSON CRITICIZED THE PROPOSED SETTLEMENT AGREEMENT AS "FATALLY FLAWED, BECAUSE IT DOESN'T CONTEMPLATE THE POSSIBILITY THAT A NEW SERVICE OR SERVICE PACKAGE MIGHT MORE APPROPRIATELY BE CLASSIFIED AS NON-COMPETITIVE. JUST BECAUSE SOMETHING IS NEW DOESN'T AUTOMATICALLY ENSURE THAT COMPETITIVE ALTERNATIVES EXIST . . ." [JOHNSON SUPPLEMENTAL TESTIMONY AT 25]. HOW WOULD YOU RESPOND?

A. What Dr. Johnson is proposing runs contrary to consumers' interests. Putting truly new services in Basket 3 ensures that Qwest bears the risk for the success or failure of the new service, not basic telephone consumers. Part of what bearing the risk means is that Qwest decides what to charge and, thus, is in control of the success or failure of the new service. This greatly improves the incentives for Qwest to offer a variety of new services in a way that benefits consumers. Either it offers a new service that consumers embrace, and it is rewarded; or it fails to do so and its shareholders incur a loss. The Commission should understand that these beneficial incentives are created only by changing the way that current regulation treats new

services, not by perpetuating the current system. In addition, the Agreement requires Qwest to submit any new service that it intends to offer in Basket 3 for review by the Commission at least thirty days in advance. The Commission will consider such a submission as provided in A.R.S. Sec. 40-250. This process will ensure that the appropriate requirements governing Basket 3 services have been met [see Attachment A (4) (a) & (e) to the Agreement]. Finally, it should be noted that the Agreement clearly states that "[t]he mere repackaging of existing Basket 1 services does not qualify existing services to be 'new services'" [see Attachment A (4) (e) (ii) to the Agreement].

Q. COX'S WITNESS DR. COLLINS ADVOCATES THAT "THE BASKET 1 SERVICES SHOULD CARRY THEIR BASKET 1 PRICE INTO THE BASKET 3 PACKAGE AND NOT THEIR TSLRIC" [COLLINS TESTIMONY AT 5]. WHAT IS YOUR RESPONSE TO THIS?

A. Dr. Collins' recommendation would actually serve to reduce competition. The very purpose of providing Qwest with additional freedom—and incentives—to offer packages and bundles of services is to permit Qwest to compete more effectively against companies such as Cox that are marketing such packages extensively. Presumably, a customer who decides to purchase a Qwest package would expect—and should receive—a discount below the "*à la carte*" prices of the individual services. As long as the package covers the TSLRIC of the services included, competitors are protected. The Agreement makes one exception to this "rule" in providing that Qwest impute the existing price of 1FR service in meeting the imputation test for any Basket 3 package that contains 1FR or its equivalent. Otherwise, as the Agreement makes clear, the Commission's existing rules which prohibit cross-subsidization of competitive services by non-competitive services and its imputation rules continue to apply and are unchanged by the price cap plan [see Attachment A (3) (g), (4) (l) to the Agreement].

Q. IN DR. JOHNSON'S LATE-FILED FURTHER SUPPLEMENTAL TESTIMONY, HE EXPRESSES THE CONCERN THAT THE PROPOSED SETTLEMENT AGREEMENT WOULD SOMEHOW WEAKEN THE COMMISSION'S SAFEGUARDS AGAINST ANTI-COMPETITIVE UNDERPRICING [JOHNSON FURTHER SUPPLEMENTAL TESTIMONY AT 2-4]. HOW WOULD YOU RESPOND TO THAT CONCERN?

A. Dr. Johnson seems to have not closely read—or perhaps simply misunderstands—the clear language of the Agreement. The Agreement preserves existing Commission rules that bar anti-competitive pricing and cross-subsidy. The Agreement, as I noted earlier, explicitly states that existing imputation rules remain in place and are not waived or overridden by the Agreement. The various hypothetical harms or theoretical problems conjured up by Dr. Johnson have no basis in fact.

Q. AT&T'S WITNESS DR. SELWYN IS CRITICAL OF THE PRICING FLEXIBILITY AFFORDED BASKET 3 SERVICES, RAISING THE POSSIBILITY OF "A CROSS-SUBSIDY FLOWING FROM NON- OR MINIMALLY-COMPETITIVE BASKET 3 SERVICES TO ACTUALLY COMPETITIVE BASKET 3 SERVICES . . ." [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 34]. WHAT IS YOUR RESPONSE?

A. First, Dr. Selwyn's scenario seems to imply that the Commission has mistakenly classified some service or services as competitive. I do not accept this premise. Moreover, Dr. Selwyn, offers no specifics to support his hypothetical concerns. Second, with regard to Basket 3 services, Qwest would be in approximately the same position as AT&T (or any other competitive firm, for that matter). Qwest would not have any greater incentive than any competitive firm would to subsidize any particular Basket 3 service. Furthermore, the proposed plan includes specific safeguards against anti-competitive pricing by Qwest. These important safeguards include separate baskets which seek to divide basic/noncompetitive services, wholesale services, and competitive/flexibly-priced services, as well as the "hard

cap" on basic services in Basket 1. Together, they prevent Qwest from financing a subsidy by raising a basic telephone service price. Further, the TSLRIC price floor for Basket 3 services is the subsidy safeguard within Basket 3. Also, as I testified above, the imputation rules in Arizona remain in place as a further safeguard against a price squeeze. The goal of establishing Basket 3 as proposed is to provide Qwest with the same opportunity that other firms in the competitive economy have to set their prices in response to conditions in the market, rather than based on arbitrary allocations of costs.

Q. AT&T'S WITNESS DR. SELWYN IS CRITICAL OF THE PRODUCTIVITY OFFSET FOR BASKET 1 IN THE PROPOSED SETTLEMENT AGREEMENT, CLAIMING THAT A PRODUCTIVITY OFFSET LESS THAN THE X-FACTOR USED BY THE FCC WOULD RESULT IN A "WINDFALL GAIN FOR QWEST" [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 7]. HE IS ALSO CRITICAL OF THE ANALYSIS UPON WHICH THE 4.2 PERCENT PRODUCTIVITY FACTOR IN THE PROPOSED SETTLEMENT AGREEMENT IS BASED [SELWYN SUPPLEMENTAL DIRECT TESTIMONY AT 9-15]. HOW DO YOU RESPOND TO THIS?

A. The 4.2 percent productivity factor in the proposed Settlement Agreement must be seen in the context of the other elements of the formula. For example, the inflation minus productivity calculation is capped at zero and has no lower bound. This is a significant concession by the company in that it has accepted the risk of inflation for the term of the price cap plan. In this aspect, the proposed Settlement Agreement formula is quite different—and more constraining—than that used by the FCC or other states that allow an increase should inflation outstrip productivity.

The Staff recommendation of a 4.2 percent productivity factor came from an analysis of the only available Arizona-specific information on Qwest's productivity. As I discussed in my previous Direct and Surrebuttal Testimonies, we relied on the most relevant data available to us, which was intrastate data from Qwest from 1988

to 1998. We did not rely on unseparated data because the accounting rules differed between the FCC and this Commission, and, therefore, the data would not be consistent for use in an Arizona proceeding regarding regulation of intrastate services. While the use of revenue and cost data may be rough approximations for the units of input and output, it is important to recognize that the development of a TFP is a significant undertaking, as I described in my Surrebuttal Testimony. A variety of calculation methods for the "X" factor have been employed across the states engaged in price cap regulation. Those methods have included intra-state, company-specific data such as I have relied upon here [Shooshan Direct at 13-14; Shooshan Surrebuttal at 7-9]. We obtained results consistent with the productivity adjustments used in other states, as shown here in Attachment A.

As I noted previously, the Staff's initial recommendation of a 4.2 percent productivity factor was further based on an analysis of the productivity factors used by other state regulators [Shooshan Direct at 14]. My analysis concluded that a 3.7 percent productivity factor, coupled with a 0.5 percent consumer dividend, was very much in line with the practices of other state regulators.

This productivity factor ensures that consumers receive at least as much benefit of Qwest's increased productivity as has occurred under rate-of-return, plus the 0.5 percent consumer productivity dividend. Further, consumers will not bear the impact of inflation that exceeds productivity. While other parties may seek a higher productivity factor, we have not found evidence to support such a factor. Finally, the context of the Settlement Agreement as a whole is important for evaluation of the productivity offset.

Q. MS. STARR, ON BEHALF OF AT&T, HAS TESTIFIED THAT THE PROPOSED REDUCTIONS IN QWEST'S INTRASTATE ACCESS RATES ARE INADEQUATE AND LESS THAN YOUR ORIGINAL RECOMMENDATION [STARR AT 7]. HOW SHOULD THE AGREED-UPON RATE REDUCTION BE VIEWED?

A. While Ms. Starr is correct that I proposed a more accelerated reduction in the price of intrastate carrier access, the reductions contained in the proposed settlement are reasonable when viewed within the overall framework of the Agreement. In a number of respects, Qwest has accepted constraints that go beyond what I proposed in my testimony in August. For example, under the proposed price cap plan, Qwest would assume all of the risk of inflation for services in Basket 1. This provides a very important protection for both residence and business customers and ensures that overall prices for services in that basket will decline in real terms over the three-year term of the plan. Further, Qwest has agreed to a cap on Basket 3 services as a whole which does not today apply to Qwest services that have been accorded pricing flexibility today. It is important to keep in mind that the Settlement Agreement represents the balancing of a variety of interests among Qwest and its diverse customer groups. The objectives of the Settlement Agreement extend beyond meeting the interests of the long-distance carriers.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

A. While Ms. Starr is correct that I proposed a more accelerated reduction in the price of intrastate carrier access, the reductions contained in the proposed settlement are reasonable when viewed within the overall framework of the Agreement. In a number of respects, Qwest has accepted constraints that go beyond what I proposed in my testimony in August. For example, under the proposed price cap plan, Qwest would assume all of the risk of inflation for services in Basket 1. This provides a very important protection for both residence and business customers and ensures that overall prices for services in that basket will decline in real terms over the three-year term of the plan. Further, Qwest has agreed to a cap on Basket 3 services as a whole which does not today apply to Qwest services that have been accorded pricing flexibility today. It is important to keep in mind that the Settlement Agreement represents the balancing of a variety of interests among Qwest and its diverse customer groups. The objectives of the Settlement Agreement extend beyond meeting the interests of the long-distance carriers.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.

Average of Productivity Adjustments Across States

State	Productivity Adjustment
California Pac Bell	5%
California GTE	4.80%
California Others	4%
Connecticut	5%
Delaware	3%
Wash DC	3%
Florida	1%
Georgia	3%
Illinois	4.30%
Iowa	2.60%
Kentucky	4%
Maine	4.50%
Massachusetts	4.10%
Michigan	1%
New Jersey	2%
New York Bell Atlantic	4%
New York Frontier	3.25%
North Carolina Basic	2%
North Carolina Other Svc	3%
Ohio	3%
Pennsylvania	2.93%
South Carolina	2.10%
Tennessee	2%
Wisconsin	3%
Average Among States	**3.2%**

J. Abel and Michael E. Clements, "A Time Series and Cross-Sectional Classification of State Regulatory Policy Adopted for Local Exchange Carriers," Divestiture to Present (1984-1998), National Regulatory Research Institute (December 1998).

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	)	DOCKET NO. T-01051B-99-105

REBUTTAL TESTIMONY REGARDING SETTLEMENT AGREEMENT

MICHAEL L. BROSCH

ON BEHALF OF

ACC UTILITIES DIVISION STAFF

November 20, 2000

BEFORE THE
ARIZONA CORPORATION COMMISSION
REBUTTAL TESTIMONY REGARDING SETTLEMENT AGREEMENT
MICHAEL L. BROSCH

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. Are you the same Michael L. Brosch who previously submitted Direct, Surrebuttal and Supplemental Testimony in this Docket?

A. Yes. My qualifications and work experience were provided in my Direct Testimony.

Q. What is the purpose of your Rebuttal Testimony Regarding the Settlement Agreement?

A This rebuttal testimony responds to the revenue requirement Supplemental Testimony of Ralph C. Smith on behalf of RUCO and Susan M. Gately on behalf of AT&T. I will explain why the Settlement Agreement revenue requirement is reasonable and in the public interest even though it does not explicitly address specific issues raised by the Staff, RUCO or AT&T directly. In particular, I will explain why the major differences in revenue requirements proposed by these two witnesses relative to the Staff are associated with a few large ratemaking adjustments that are not appropriate and should not be used to reduce the $42.9 million settlement revenue requirement.

Q. Mr. Smith's Supplemental Testimony notes that the Settlement Agreement revenue requirement was a compromise reached "without an issue-by-issue" negotiation (Supplemental Testimony, page 2, line 2). Does such an approach render the resulting revenue requirement inappropriate or arbitrary?

A. No. As I explained in my earlier Supplemental Testimony, the advice I provided to Staff Counsel in support of negotiations was mindful of the adjustments and issues raised by all parties to the proceeding, with specific reference to several of Staff's adjustments I considered to be most "at-risk". It should be noted that the many other Staff adjustments not specifically noted in my Supplemental Testimony were all effectively "won" in negotiations because the revenue requirement was based upon Staff's rate base, rate of

return and starting point adjusted operating income. There is nothing arbitrary about a vigorously negotiated compromise of the revenue requirement that is not burdened with detailed issue-by-issue findings in favor of specific parties on each of the dozens of adjustments proposed in this proceeding. In fact, any attempt to reach a settlement by specific resolution of each proposed adjustment would likely have required detailed concessions that the parties would have been unwilling to make. Additionally, such an approach virtually guarantees full litigation of each of the various issues so that any non-signatories could contest the various concessions made or not made in such a settlement.

Q. At page 2 of his Supplemental Testimony, RUCO witness Mr. Smith quotes your response to a RUCO data request stating, "The revenue requirement calculations of the other parties included adjustments and positions not advocated by Staff that, upon review by Utilitech, were not explicitly factored into the Settlement Agreement revenue requirement." Were these adjustments not "factored in" for specific reasons?

A. Yes. In my opinion, most of the RUCO adjustments were implicitly considered to the extent they overlapped Staff's adjustments. However, two of the adjustments proposed by RUCO that were intentionally not "factored in" for settlement purposes are simply inappropriate and should have been disapproved if formally presented in a contested case. These include RUCO's Adjustment E-1 that reverses all of the Company's proposed Toll Revenue Loss Annualization ($3.3 million revenue requirement impact) and RUCO's Adjustment E-22 that would credit another $22.9 million of estimated Gain on Sale of Arizona exchanges into the revenue requirement. These two adjustments were not included in Staff's case because Qwest's competitive toll losses are clearly a known and measurable change that should be recognized and because the gain on sale of exchanges is being separately addressed in another pending Docket before the Commission.

Q. Mr. Smith's Supplemental Testimony discusses RUCO adjustments that are different from or in some instances supplemental to adjustments presented by Staff. Are there any omissions within RUCO's proposed revenue requirement that cause Staff's revenue requirement to serve as a better beginning point for Settlement purposes?

A. Yes. Staff was careful to post adjustments that were required to reflect known corrections to the Company's prefiled case, even if making such adjustments increased the revenue requirement. The RUCO filing does not reflect any of these corrections. The revenue requirement advocated by RUCO is therefore incomplete and should be increased to recognize at least the following Staff adjustments that were omitted by RUCO:

Reversal of Depreciation Reserve Proforma (Staff Schedule B-5)
Affiliate Transaction True-up Normalization (Staff Schedule C-9)
Out of Period Property/Other Taxes (Staff Schedule C-25)

The combined effect of these needed adjustments that were not made by RUCO is an increased revenue requirement of $12.2 million[1]. These omissions in RUCO's filing, along with the Toll Loss and Gain on Sale items mentioned above and RUCO's lower return on equity recommendation, explain most of the difference between Staff's and RUCO's recommended revenue requirements.

Q. Mr. Smith's Supplemental Testimony at page 3 also indicates that RUCO has recommended a revenue decrease rather than an increase. Does the RUCO rate reduction rely upon adjustments comparable to or "overlapping" Staff's SOP 98-01, incentive compensation, and out of period wage increase disallowances that were implicitly compromised in Staff's negotiations with Qwest?

A. Yes. The same litigation risks I referenced in my earlier Supplemental Testimony with respect to Staff's advocacy of these adjustments would, in my view, also apply to RUCO's corresponding adjustments. However, Mr. Smith's reference to RUCO's recommended overall rate reduction for Qwest is dependent in large part upon an assumption that RUCO and Staff would fully prevail on these significant issues, even though the adjustments represent major policy issues not previously resolved in a rate case before the ACC in the manner proposed by Mr. Smith. RUCO Adjustments E-15 (SOP 98-01), E-12 (Incentive Compensation), E-13 (Management Wages and Salaries – Post Test Year), and E-14 (Occupational Wages and Salaries – Post Year End)

[1] See Staff Schedule E, Column D, at Lines 9, 24 and 40.

collectively reduce Qwest's asserted revenue requirement approximately $44.9 million, as filed in RUCO's evidence.[2]

Q. At page 4 of his Supplemental Testimony, Mr. Smith references the return on equity ("ROE") recommendation of RUCO witness Mr. Legler of 11.5 percent. How does this ROE compare with Qwest's recommendation and the compromise ROE embedded within the Settlement Agreement?

A. Qwest proposed an ROE of 14.0 percent in its asserted revenue requirements. The Settlement Agreement reflects the adoption of Staff's proposed ROE of 11.75 percent, only one fourth of one percent (25 basis points) higher than is advocated by RUCO. Mr. Legler's modestly lower recommended ROE would change the Settlement Agreement revenue requirement by about $3 million. It is my belief that adoption of Staff's ROE is a reasonable compromise for settlement purposes, given the above stated range of recommendations and the inherent judgment involved in determining ROE for ratemaking purposes.

Q. According to AT&T witness Ms. Gately in Supplemental Direct Testimony at page 2, the Settlement Agreement revenue requirement "can only be described as arbitrary and began from an unreasonably inflated revenue requirement base". She then characterizes the $42.9 million amount as a "split the baby" treatment that must be "accorded to the proposed adjustments of other interested parties as well". How do you respond?

A. The Settlement Agreement revenue requirement did not begin with Qwest's asserted revenue requirement, but instead used Staff's rate base and rate of return outright. The settlement also used Staff's adjusted operating income rather than Qwest's, with upward adjustment to recognize that Staff would likely not prevail on every one of its many adjustments. For Ms. Gately's "split the baby" characterization of the settlement to be correct, the revenue requirement would be more than $104 million, the mid-point between Qwest's asserted $201 million revenue requirement and Staff's $7.2 million recommendation. It certainly does not follow from her mischaracterization that every

[2] RUCO Schedule E Revised, Page 4 of 7, Sum of Line 46 for adjustments E-12 through E-15.

unsubstantiated adjustment proposed by every non-signatory party must now be used to reduce the revenue requirement in a 50/50 factoring process.

Q. Ms. Gately references "nine specific corrections" in her Supplemental Direct Testimony starting at page 9. Then she claims seven of these AT&T adjustments "were not addressed by Staff and Qwest in the development of the negotiated revenue increase". How do you respond?

A. The seven listed items at pages 9 through 12 are not "corrections" at all, but are instead improper disallowances and imputation adjustments that are based upon incorrect assumptions, misunderstandings of Staff's case, improper ratemaking policies and are inconsistent with prior ACC Decisions. I will address her listed items in order:

1) Staff verified that Local Number Portability costs were properly treated in Qwest's filing through the jurisdictional separations process, through a series of detailed data requests and analyses[3]. No ratemaking adjustment is required to further adjust for LNP.

2) Qwest's interconnection costs are ongoing in nature and were not at extraordinary or non-recurring levels in the test period[4]. No ratemaking adjustment is required in this area.

3) Staff's filing and the Settlement did reflect the only plant and depreciation adjustments that could be supported with evidence applicable to Arizona continuing property records[5], even though Staff was fully aware of and had investigated the FCC audit reports and Qwest's responses to same. AT&T's proposed extrapolation of the pending FCC audit report to Arizona is inappropriate.

4) Staff's filing and the Settlement did reflect full imputation to eliminate FCC deregulated service losses for ratemaking purposes[6], contrary to Ms. Gately's representations to the contrary.

5) Staff's filing and the Settlement reflected sufficient imputation to meet the prior Settlement Agreement requirements[7], as previously ordered by the Commission upon appeal and remand in the last Arizona rate case.

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3 See, for example, data requests UTI 51-13, 54-01, 54-02, 57-11 and RUCO 28-17.
4 See, for example, data requests UTI 13-22, 24-19 and 17-03.
5 Staff Schedules B-1 and C-22 disallowed Unrecorded Plant Retirements estimated amounts.
6 Staff Schedules C-17 and C-18 reflect FCC Deregulated Services imputation and related separations.
7 Staff Schedule C-5 imputes directory revenues based upon the prior ACC-approved Settlement Agreement.

6) Staff's filing and the Settlement reflect full elimination of the $66 million pension asset from rate base, contrary to Ms. Gately's representation[8]. It is necessary, however, to remove the corresponding deferred tax reserves associated with such elimination, which are improperly ignored in AT&T's proposed adjustment.

7) Staff investigated Qwest's Post-retirement Benefits Other Than Pension (PBOP's) proposal for compliance with the Commission's criteria, as referenced by Ms. Gately, and found the Company's proposal to be in substantial compliance with the Commission criteria.

Q. Does this conclude your Rebuttal Testimony Regarding Settlement Agreement?

A. Yes.

[8] Staff Schedule B-3 at line 1 disallows the $66 million pension asset.